

July 27, 2020

The Honorable Eugene Scalia  
Secretary of Labor  
Office of Regulations and Interpretations,  
Employee Benefits Security Administration  
Room N-5655  
U.S. Department of Labor  
200 Constitution Avenue NW  
Washington, DC 20210  
Attention: Financial Factors in Selecting Plan Investments Proposed Regulation

By Federal eRulemaking Portal

Re: RIN 1210-AB95

Dear Mr. Secretary:

I write in response to a request for comments by the Department of Labor on its proposed rule, “Financial Factors in Selecting Plan Investments,” posted on June 30, 2020.

My name is Ellen R. Wald. I am a senior non-resident fellow at the Global Energy Center at the Atlantic Council, the founder and president of Transversal Consulting, and an adjunct professor at Jacksonville University. Past appointments include visiting assistant professor at the University of Georgia, Majewski Fellow in Economic Geology at the American Heritage Center at the University of Wyoming, Visiting Scholar at the University of Cambridge, and lecturer at Boston University. I am a columnist on the energy industry and investing at Forbes.com and investing.com. I earned my doctorate in history, with a focus on the energy industry, at Boston University, and my A.B. magna cum laude from Princeton University. The views I share in this letter are mine and do not represent those of any institution with which I am affiliated.

The rule is worthwhile and necessary. Funds based on equities that are deemed compliant with ESG (environmental, social and governance) criteria are necessarily not focused on the optimal financial outcome. Several studies address the comparison between ESG fund performances and index or other fund performances, and others better suited than I can demonstrate that ESG has not matched up with other funds. My expertise lies in energy, so I will provide an explanation of why the characteristics of ESG in the energy and environment spaces do not lead to the best investments to prioritize returns for retirement funds. I will address three arguments that show that ESG funds when investing in the energy and environment spaces are not centered around financial outcomes or the fiduciary responsibilities of the fund managers to the investors. These three arguments are not exclusive.

One, ESG funds, particularly those with attention on energy or the environment, lack diversification. This is not simply a peculiarity of ESG funds but a function of them. This lack of diversification can only be ignored if financial outcome is not the priority.

Two, ESG funds are likely to invest in the wrong businesses as a function of their limiting criteria and their reporting requirements. This can lead to two negative results: missing out on investing in truly groundbreaking sustainability innovation and investing in technology that is likely to fail. This means that ESG investing is not an attempt to seek out the best investing prospects, and it also, ironically, means that ESG investing is likely to lead to misallocation of capital and hampering truly groundbreaking “green” technology.

Three, there are significant signs that a bubble is being created around ESG investing which could lead to negative fallout for pension funds invested in ESG over the long term. Some of the language from ESG-involved institutions, like MSCI, indicate an effort to promote ESG investments for their social value and thus raise the value of ESG investments based on something other than fundamentals. In the energy and environment spaces, in particular, this could lead to a bubble bound to burst at the expense of invested retirement funds.

### **1. Lack of Diversification**

Lack of diversification in funds leads to increased risk and, over the long run, greater possibility of a negative event, meaning a significant and perhaps precipitous fall in value. In his study, “Environmental, Social, and Governance Investing: An Evaluation of the Evidence,” Wayne Winegarden found that in the waste and clean tech sector, ESG funds averaged 48.65% committed to just the top 10 equities in the fund. In one waste and clean tech fund, EVX, he found that the top 10 equities accounted for an alarming 64.03% of the portfolio.<sup>1</sup>

Critically, this lack of diversification is a function of ESG investing. For an energy-related company to qualify as ESG in most funds, it must typically report an array of information beyond what is legally required for a public company. Once it has reported that information to the various fund managers or to third parties like SASB (Sustainability Accounting Standards Board), it must qualify according to their standards. These two limitations decrease the pool of available equities for a fund to invest in. As a result, diversification drops.

It is impossible to determine just how small the pool of equities is for investing for any given fund. That depends on how many companies responded with reporting and qualified according to the standards used by that fund. However, it is possible to look at the availability of equities for investing with particular standards. SASB lists on its website companies that have reported information in certain categories/industries.<sup>2</sup> For “Renewable Resources and Alternative Energies,” SASB lists only three companies: Neenah, Sunrun and TPI Composites. Under “Infrastructure” it lists a variety of utility companies that reported including PSEG, Xcel Energy and conEdison. SASB even lists some legacy oil, gas and petroleum companies like Chevron, Phillips 66 and Hess. Also included are younger fossil fuel firms and oil services companies like Whiting Petroleum and Haliburton. Overall, though, the number of energy-related companies is small and the diversity is minimal. SASB only lists 313 companies in all industries. Even with the expectation that the list would grow, it would still be limited, and that list does not even tell us how these companies were ultimately scored according to SASB’s standards.

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<sup>1</sup> Wayne Winegarden, *Environmental, Social, And Governance (ESG) Investing: An Evaluation of the Evidence* (San Francisco, CA: Pacific Research Institute, 2019).

<sup>2</sup> Sustainability Accounting Standards Board, “SASB Reporters,” accessed July 21, 2020, <https://www.sasb.org/company-use/sasb-reporters/>.

The diversification situation may be improved over time, but it cannot be fixed or significantly ameliorated without drastically changing and negating the purpose of the ESG system. In fact, it could be exacerbated if ESG parameters at any given fund become stricter or if more publicly traded companies push back against the request for ESG reporting. This lack of diversification can only be ignored if financial outcome is not the priority.

## 2. The Wrong Investments

The ESG label is an amorphous designation. In the energy space, ESG investing generally appears to seek the promotion of fuel and power generation technologies that either do not hurt the environment or cause less damage to the environment than other operations. However, in the energy sector, many of the firms that qualify as ESG (according to some standards, because ESG designations are not universal) are actually less likely to succeed in the goal of “clean” energy than companies that fail to meet the ESG standards. This is bound to lead to a failure to promote truly promising “clean” technology and, more importantly for pension funds, a miss on the technologies that have the best potential for financial success.

There are currently a variety of fields in which researchers are working diligently to achieve a breakthrough big enough to significantly minimize the environmental impact from fuels and power generation. These include storage (battery) technology, carbon capture, fuel efficiency and emissions of engines, biofuels, small modular nuclear reactors, tide power and fusion power. Other technologies can still be improved, including solar panels and wind turbines.

It might surprise many ESG investors and workers and retirees whose retirement funds might be invested in ESG that much of the funding and work for some of the most promising new technologies comes from legacy energy firms that may not match their funds’ ESG standards. For instance, ExxonMobil has been one of the major drivers in biofuels research, investing \$300 million in the decade ending in 2019.<sup>3</sup> Furthermore, “ExxonMobil is a leader in one of the most important next-generation low-greenhouse gas emissions technologies, capturing about 7 million tonnes per year of CO<sub>2</sub>. Since 1970, ExxonMobil has cumulatively captured more CO<sub>2</sub> than any other company — accounting for more than 40 percent of cumulative CO<sub>2</sub> captured.”<sup>4</sup> ExxonMobil has invested \$10 billion, “to develop lower-emission energy solutions since 2000.”<sup>5</sup> ExxonMobil has also partnered with more than 80 universities around the world in programs such as a, “collaboration with Princeton University in fields including solar and battery technology, [and] an agreement with the University of Texas to study carbon storage and other technologies.”<sup>6</sup>

Yet, despite the resources ExxonMobil puts behind potential “clean” technology, it does not appear on many—if any—ESG lists. And ExxonMobil is not the only company in this

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<sup>3</sup> ExxonMobil, “Innovating energy solutions: Research and development highlights,” accessed July 21, 2020, <https://corporate.exxonmobil.com/Research-and-innovation/Research-and-development-highlights>.

<sup>4</sup> ExxonMobil, “Carbon capture and storage (CCS),” accessed July 21, 2020, <https://corporate.exxonmobil.com/Research-and-innovation/Carbon-capture-and-storage>.

<sup>5</sup> ExxonMobil, “Climate change,” accessed July 1, 2020, <https://corporate.exxonmobil.com/Energy-and-environment/Environmental-protection/Climate-change>.

<sup>6</sup> ExxonMobil, “University and National Labs partnerships,” accessed July 21, 2020, <https://corporate.exxonmobil.com/Research-and-innovation/University-and-National-Labs-partnerships>.

situation. Saudi Aramco (traded on the Saudi exchange, Tadawul) and BP are other examples of traditional oil firms that invest heavily in “clean” tech R&D and most likely would be missed by ESG funds. Both companies are involved in an array of endeavors to lessen the environmental impact of carbon emissions and to improve alternative energies. Aramco purchased a company called Converge in 2016, which decreases impact on the environment by combining greenhouse gas CO<sub>2</sub> with hydrocarbon feedstocks to create polyols that are used in the fabrication of a variety of household appliances, packaging, medical applications and more.<sup>7</sup> Aramco also uses renewable energy to power oil wells,<sup>8</sup> something it began doing in the 1970s when it was still partially owned by American firms and it utilized solar panels from Exxon’s Solar Power business (then a pioneer in the technology). These practical uses of green technologies help improve the applications, but Aramco also has an R&D department that works on projects like a carbon capture vehicle.<sup>9</sup> Aramco hosts 11 research centers, including 3 in the United States.<sup>10</sup> Failure to at least investigate Aramco’s work in these fields would mean that an ESG fund can miss out on innovation that can help the environment and bring impressive returns.

BP has several alternative energy projects at various stages, often engaging in joint ventures. It is a partner in a Brazilian bioenergy program utilizing sugarcane and another bioenergy project with Dupont that uses corn. It operates 9 wind power sites in the United States, and it is a 50% owner of a solar power firm. BP is also, “developing a number of digital platforms to connect consumers with local, low carbon electricity to power their homes and transport, and are exploring opportunities to create value at the interplay between gas and renewable energy.” All of this application and innovation would be missed out by investors if either BP chooses not to submit the requested information or BP does not meet amorphous ESG standards.<sup>11</sup>

When ESG funds ignore ExxonMobil and others, ESG investors are missing out. It is irrelevant whether these firms fail to make the ESG lists because the firms don’t complete the information requests or because they fail to comply with some ESG standards. The ESG investors are missing out both on investing in (and supporting) potentially transformative new technology and on the potential windfall that the breakthrough will bring. Long term energy investing is different than other sectors in that there is a widely held expectation that true innovations will come to the industry, and those innovations are expected to be tremendously impactful. If that is true, it is negligent to ignore potential sources of those innovations simply because they don’t fill out the information requests or comply with the standards.

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<sup>7</sup> Saudi Aramco, “Converge,” accessed July 24, 2020, <https://www.saudiaramco.com/en/creating-value/products/converge>.

<sup>8</sup> Saudi Aramco, “Using renewables to power unconventional gas wells in Wa’ad Al-Shamal,” accessed July 24, 2020, <https://www.saudiaramco.com/en/news-media/news/2019/renewables-powering-gas-wells-waad-al-shamal>.

<sup>9</sup> Ellen R. Wald, “Watch Out Tesla, Aramco’s Carbon Capture Truck Is Coming,” *Forbes*, December 10, 2017, <https://www.forbes.com/sites/ellenwald/2017/12/10/watch-out-tesla-aramcos-carbon-capture-truck-is-coming/#74f6f75654c5>.

<sup>10</sup> Saudi Aramco, “Global research centers,” accessed July 24, 2020, <https://www.saudiaramco.com/en/creating-value/technology-development/globalresearchcenters>.

<sup>11</sup> BP, “Alternative energy,” accessed July 24, 2020, <https://www.bp.com/en/global/corporate/what-we-do/alternative-energy.html>.

Just as ESG can cause investors to miss out on the big innovations in energy, it can also lead to commitment to less promising technologies that may fail spectacularly. Instead of seeking out the best potential technologies that would both transform environmental protection and create large profit, ESG investing necessarily discards a large portion of the best funded and most promising research.

In another area of the energy industry, battery technology, ESG investing can run counter to both the purpose of ESG and profit. SASB lists four issues likely to be material to an ESG designation in the battery sector: Energy Management, Employee Health & Safety, Product Design & Lifecycle Management and Materials Sourcing & Efficiency. Yet, it does not include Waste & Hazardous Materials Management or Ecological Impact even though many batteries are made from hazardous materials. It does not include Human Rights & Community Relations, Labor Practices or Business Ethics even though a particular concern in the sector is avoiding raw materials (such as cobalt and lithium) that were mined by child or slave labor.<sup>12</sup>

Battery technology is expected to be a crucial new innovation in the effort to protect the environment in this century and beyond. Serious improvements in battery technology would help to protect our environment and, more importantly for retirement funds, lead to financial success. The industry understands that four breakthroughs are needed:

**Storage capacity**—if we can build batteries or systems of batteries that store enough power, we can make solar arrays and wind fields more efficient even though they fail to produce power at times.

**Charging speed**—if we can build batteries that charge more quickly, it will allow us to replace engines with batteries even in machines that need regular refilling of fuel.

**Capacity degradation**—if we can build batteries that last more years no matter how often they are charged, their value will be vastly improved.

**Size and weight**—if we can build batteries that are smaller and lighter, they can be much more useful for transportation. One of the main obstacles for using batteries in airplanes, for instance, is that the battery weight is too much, and that weight barely decreases over time, unlike fuel which is burned off during the flight.

The company or companies that achieve breakthroughs in these four areas above will be in a position to succeed. These breakthroughs could come from anywhere, including that ExxonMobil-Princeton University partnership. Truly transformative energy technology will not be identified by amorphous ESG standards. As a result, it will not receive sufficient support from ESG investors, and those investors will miss out on the profit.

### **3. Dangers of inflated valuations and a bubble**

One of the primary dangers of the drive toward ESG investing is the inflation of valuations for ESG firms and ESG funds. By definition, ESG exists to give investors new criteria to consider when choosing where to place assets. At best, ESG offers additional criteria; at worst, it replaces traditional criteria like profit, growth, dividends, etc. with ESG standards and these amorphous designations. All of this can lead—and may even be designed to lead—to inflated valuations.

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<sup>12</sup> Sustainability Accounting Standards Board, “SASB Materiality Map,” accessed July 21, 2020, <https://materiality.sasb.org/>.

MSCI is one of the most involved institutions in the business of ESG funds and ESG standards. As MSCI puts it, “MSCI has been at the forefront of providing data, research and other tools to help enable ESG integration across the entire investment process.” MSCI is also eager to push up the value of not only ESG funds but ESG-designated companies as well. “MSCI urges all investors globally to integrate ESG considerations into their investment processes.”

MSCI has stated explicitly that it thinks there will be a great movement of capital from non-ESG investments to ESG investments simply because they are ESG (and presumably not because of the fundamentals). “We believe that this convergence of factors (climate change, social attitudes, institutional governance, technological innovation) will significantly impact the pricing of financial assets and the risk and return of investments and lead to a large-scale re-allocation of capital over the next decades.”

This is not about fundamentals as much as it is about popularity at the moment. MSCI feels the need to claim that these ESG “factors” do not constitute a “fad,” but the market and the perspectives of investors always change. MSCI goes so far as to attempt to persuade investors to participate in ESG investing in order to decrease the risks of that very type of investment. It makes an, “urgent call by MSCI to all investment institutions worldwide to embrace this new world... and mitigate the inherent risks it brings.”<sup>13</sup> In other words, the argument here is that more investment in ESG would mitigate the inherent risks of ESG. Notably, those risks are not delineated. However, more investments and more capital only create inflated valuations and a bubble. Retirement funds are meant for the long term, and a policy of ESG investing would tie those funds to ESG over years. If the pro-ESG sentiment decreases and the valuations don’t match the fundamentals, the bubble would be set to burst.

## Conclusion

As the Wall Street Journal concisely argued earlier this month, the conclusions about past performance of ESGs depend on what is studied and how it is studied.<sup>14</sup> There is significant evidence that ESG has failed to match the market in the past. There is also evidence that some ESG funds got lucky during the last few months when, by chance, companies those funds disavow suffered as a result of the coronavirus pandemic and the economic shutdowns.

There are plenty of reasons to keep ESG investing away from pension funds and retirement funds based on the nature of ESG. ESG funds fail to match the diversification of other investment strategies, and this is a function of the ESG system that cannot be ignored. This can be particularly harmful for retirement planning.<sup>15</sup> ESG funds are also prone to investing in the wrong businesses and technologies, missing out on truly transformative businesses and participating in businesses that are more likely to fail. This can mean both a failure to support environmental initiatives (in the energy and environment space) and a failure to maximize return.

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<sup>13</sup> *The MSCI Principles of Sustainable Investing* (MSCI ESG Research LLC, 2019) accessed July 22, 2020, <https://www.msci.com/documents/10199/16912162/MSCI-ESG-House-View-FINAL.pdf/63bba1a1-aecf-ba80-aa49-7910748ed942?t=1579587918450>.

<sup>14</sup> James Mackintosh, “ESG Investing in the Pandemic Shows Power of Luck,” *The Wall Street Journal*, July 15, 2020. <https://www.wsj.com/articles/esg-investing-in-the-pandemic-shows-power-of-luck-11594810802>.

<sup>15</sup> Peter Lazaroff, “Why ESG Funds Don’t Belong in Your 401(k),” *The Wall Street Journal*, July 8, 2020. <https://blogs.wsj.com/experts/2020/07/08/why-esg-funds-dont-belong-in-your-401k/>.

Perhaps worst of all, ESG investing risks a bubble. More mania would not “mitigate the inherent risks it brings,” but it would do the opposite. This is particularly problematic for retirement funds that are designed for the long term and may become attached to ESG for too long based on policy and social pressure on the fund management team.

The retirement funds of America’s workers are there to provide for them after employment. The most important result of a retirement fund is obtaining sufficient assets to fund those retirements. Retirement funds are not social and environmental activist organizations. If ESG does not make for the best investments, ESG should not be chosen. All evidence points to ESG as a poor choice as an investment vehicle for retirement funds.

Sincerely,

Ellen R. Wald, Ph.D.